

## 4.6 The roles of foreign aid and multilateral development assistance

### Learning Outcomes

- Explain that aid is extended to economically less developed countries, either by governments of donor countries, in which case it is called official development assistance (ODA), or by nongovernmental organizations (NGOs).
- Explain that humanitarian aid consists of food aid, medical aid, and emergency relief aid.
- Explain that development aid consists of grants, concessional long-term loans, project aid that includes support for schools and hospitals, and programme aid that includes support for sectors such as the education sector and the financial sector.
- Explain that, for the most part, the priority of NGOs is to provide aid on a small scale to achieve development objectives.
- Explain that aid might also come in the form of tied aid.
- Explain the motivations of economically more developed countries giving aid.
- Compare and contrast the extent, nature, and sources of ODA to two economically less developed countries.
- Evaluate the effectiveness of foreign aid in contributing to economic development.
- Compare and contrast the roles of aid and trade in economic development.
- Examine the current roles of the IMF and the World Bank in promoting economic development.

### What is foreign aid?

FDI is a source of foreign currencies that helps developing countries close the **savings gap**. It can provide the investment funds necessary for countries to increase **productivity** and break free from the **cycle of poverty**. Foreign aid is also a source of investment funds. Foreign aid provided by governments is called official development assistance (ODA). Aid is also provided by non-governmental organizations (NGOs).

### Distinguish between bilateral and multilateral aid

Bilateral aid is aid given by one country to another country. The aid is given directly to the country. Aid is called multilateral aid when countries give money to international organizations such as the World Bank, the IMF, and UNICEF (United Nations children's fund). The international organization is then responsible for delivering the aid.

### Distinguish between loans and grants

Aid can be money loaned to a country. The receiver of the loan must pay back the money along with **interest payments**. A low **rate of interest** is charged on the loan and the country is given a long time to pay back the loan. A grant is money given to a country that does not have to be repaid.

### Distinguish between tied aid and untied aid

Tied aid is aid given to a country that must be used for a specific purpose. For example, aid can be given to a country only if the country agrees to use the money to buy food or other goods such as **capital** goods from the **donor country**. Untied aid is given to a country which it can then use to buy goods and services from any approved country.

### Distinguish between project assistance, technical assistance, and commodity assistance

Project assistance is a type of tied aid. It must be used to build infrastructure, such as schools, to increase educational attainment and the infrastructure required to provide fresh water supplies in order to improve health.

Technical assistance is a type of tied aid. For example, the IMF, through multilateral aid, provides technical assistance to governments concerning **macroeconomic policy** so that the government can create a stable and effective financial and banking sector. Other agencies provide training relating to the installation, operation,

### Subject vocabulary

**savings gap** occurs when low incomes earned in a country are not high enough to provide savings for those who wish to borrow for investment purposes

**productivity** the quantity of output per unit of input

**cycle of poverty** occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low.

**interest payments** the money paid at regular intervals on loans

**rate of interest** the percentage amount charged by a lender for money borrowed or paid to a person for saving money

**capital** (goods) manufactured goods that are used in the production of other goods

**donor country** a country that provides aid to another country

**macroeconomic policy** government policy aimed at affecting aggregate indicators such as unemployment, inflation, and GDP

## Subject vocabulary

**human capital** this relates to the store of knowledge and the set of skills that a worker possesses which can be used in the production process. The higher the value of human capital the more productive the worker is. Human capital can be improved through investment in education and training.

**physical capital** any manufactured good that is used in the production of other goods and services such as machinery and buildings

**economic growth** an increase in real GDP

**economic development** the sustained increase in the standard of living and well-being of the population of a country

**commodities** raw material or primary agricultural products, such as copper or coffee

**intermediate goods** a good or service that is used in the production of a final good

**fiscal policy** government policy designed to achieve macroeconomic objectives through government expenditure and taxation

**cycle of poverty** occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low

**unemployment** occurs when there are people actively looking for work at the equilibrium wage rate but are not able to find work

**savings** income that is not spent or paid in tax

**investment** the addition to capital stock

**productivity** the quantity of output per unit of input

## Glossary

**sanitation** the removal/treatment of waste/water

**infrastructure** the basic structure/systems of a country (e.g. roads/railways)

and maintenance of modern capital equipment. The aim is to raise the productivity of **human capital** and **physical capital** so that developing countries can industrialize more quickly. The quantity and productivity of labour and capital are important determinants of **economic growth** and **economic development**.

Commodity assistance comes in the form of a grant for the purchase of **commodities** and **intermediate goods**, which are used in the production process. Examples include fertilizer, cement and other building materials, and wheat.

## Distinguish between humanitarian aid and development aid

Humanitarian aid is short-term aid and is given in response to human suffering caused by natural disasters, such as earthquakes and droughts, and to relieve suffering caused by conflict. The aid comes in the form of grants from a number of sources. Some will be ODA, some will come from NGOs.

After a natural disaster emergency aid is initially provided to pay for what is needed immediately such as tents and blankets, water, food, fuel, and medicines. Some of the food is paid for and distributed by NGOs such as Oxfam and some medicines are paid for and distributed by NGOs, such as Médecins Sans Frontières, who also send doctors and nurses to disaster regions.

Official Development Aid is given to help a country improve the long-term welfare of its people by promoting the economic development of a region or country. Development aid is multilateral or bilateral official development assistance. This means that the aid comes from governments. It comes in the form of a long-term loan at favourable interest rates and can be tied or untied.

Many developed countries budget for ODA when planning **fiscal policy**. Listed below in Table 84.1 are the six countries which provide the most assistance as measured by percentage of GDP. Figures are for 2013.

Country	Percentage of GDP
Luxembourg	1%
Sweden	0.99%
Norway	0.93%
Denmark	0.84%
Netherlands	0.71%
UK	0.56%

**Table 84.1** Source: OECD

The United Nations came to an agreement in 1970 that developed countries should aim to put aside 0.7% of GDP for ODA. By 2013 only 5 countries have achieved this target.

Non-official development aid is provided by NGOs and individual citizens. This aid is on a smaller scale than ODA. Oxfam, for example, place workers and materials in areas of poverty to provide direct help. They are involved with activities that promote health through the improvement of **sanitation** infrastructure and they provide support to improve crops. Wateraid is an NGO that promotes health by providing assistance in the provision of clean fresh water supplies in order to reduce disease.

One Cause is an NGO with a specific aim. This is their mission statement: 'We passionately believe that education is the answer to fighting poverty. We are committed to raising awareness and funds for the provision and advancement of education to those communities around the world that have little or no access to education. Our aim is to provide a socially, financially, and environmentally self-sustaining model so that local communities are empowered and equipped to pursue a more prosperous and sustainable future.'

## Why do developed countries give aid?

Humanitarian aid is given to reduce the suffering caused by manmade disasters, such as civil war, and natural disasters, such as a tsunami, by providing food, water, shelter, and medical services.

Longer-term aid is given to promote economic development and growth. LDCs are in the **cycle of poverty** with high levels of **unemployment** and low income leading to low **savings** and **investment**. The quantity and quality of capital is low and they are unable to industrialize and increase **productivity** in order to break free from the cycle of poverty. Aid is the inward investment LDCs need in order to increase the quality of human capital and physical capital and increase income, savings, and investment and thereby improve the well-being of their citizens. Many LDCs lack the basic **infrastructure** needed for economic growth and development.

Clean water supplies, sanitation, health and education services, transport, and communication networks are all necessary to improve economic development and increase the value of the **Human Development Index**. Because of low levels of income, countries are unable to build the infrastructure.

**Model sentence:** Project aid has an important role to play in the provision of the infrastructure required for economic growth and development.

Aid is sometimes given for political reasons. For example, during the Cold War, the Western bloc and the Soviet bloc gave aid to countries in Africa, Southeast Asia, and South America in an attempt to win **allies**. Aid has been used by Russia, China, and the US to influence the internal politics and the struggle for power in a country. For example, in 1979 and 1980 the US and the UK gave aid to, amongst other things, assist the Afghan forces fighting against the Soviet-led forces. In 2014 Russia is providing aid to support the Syrian government's fight against anti-government Syrian groups.

Economists, researching the motivations for aid giving, estimate that China has given \$75 billion for development projects in Africa in the last decade to try to gain political and economic influence. Some economists and politicians argue that the aid is given so that China can secure the supply of **natural resources** found in many African countries that are needed for economic growth.

Developed countries give aid to increase the size of their own markets. Bilateral tied aid is given on the basis that the developing country buys goods and technical expertise from the donor country thereby increasing the size of the donor country's market and the sale of its exports.

## Compare and contrast the extent, nature, and sources of ODA to two economically less developed countries

The Organization for Economic Co-operation and Development (OECD) is an international organization of 34 countries. Its aim is to promote democratic practices and a free market economy. The OECD website is a useful source of statistical information concerning aid and economic development. Information from the OECD has been used to answer this question, some of which is shown in tables 84.2 and 84.3, the statistics used are from 2012 and the two countries investigated are Mali in East Africa and Bangladesh in South Asia.

Mali's population of 14.9 million is much smaller than the population of Bangladesh, which has a population of over 150 million. Both have low **GNI** per capita. Mali's is \$660 and Bangladesh's is \$770. Income is very unequally distributed in both countries. The **Gini-coefficient** of both Mali and Bangladesh are under 0.34 and are amongst the lowest in the world. This means that a very high percentage of the population earn a very small percentage of total **national income**. HDI is 0.344 and Bangladesh's is 0.515 indicating that literacy rates, life expectancy, and **GDP** per capita are higher in Bangladesh than in Mali.

Mali received \$1,001 million in ODA, whilst Bangladesh received \$1,498 million. Bangladesh receives more ODA in total but receives much less ODA per capita. Mali's ODA per capita = \$1,001 million/14.9 million people = \$67.18. Bangladesh's ODA per capita = \$1,498 million/150.5 million people = \$9.95.

In Mali 73% of ODA is bilateral therefore 27% is multilateral. In Bangladesh ODA is more evenly split, 55% is bilateral therefore 45% is multilateral aid. It can be assumed that most of Mali's bilateral aid came from the US, because the US gave \$311 million in ODA which represents 31% ( $311/1001 \times 100$ ) of the total ODA given to Mali by the top ten donors.

Bangladesh received \$359 million from the International Development Association (IDA) which is the World's Bank fund for poor countries. This means that 24% of all ODA given to Bangladesh from the top ten donors was multilateral aid from the World Bank.

In Mali 40% of ODA is spent on health and other social sectors, which includes water and sanitation, so we might expect to see increases in life expectancy. Between 2002 and 2012 life expectancy has increased by 5 years from 47 years to 52 years, a relatively large increase. However, life expectancy in Mali is still one of the lowest in the world. Only 13% of ODA was spent on education and literacy rates have improved very little over the years. It was 31% in 2012, the fourth lowest in the world. Only 2% of ODA was spent on economic infrastructure. Mali is dependent for most of its GDP on the production of **primary goods** and has made little progress towards industrialization.

Bangladesh, on the other hand, spent 36% of ODA on economic infrastructure. Industrialization is one of the government's main aims. The government has recently invested heavily in transport infrastructure including high speed trains, more airports, and the road network. The country's ship building industry is growing steadily. By 2012, more than 75% of Bangladesh's **export revenue** came from the garment industry. Bangladesh is no longer dependent on the sale of primary goods for its export revenue. Industrialization has led to a fall of 25% in the poverty rate since 1990 and GDP per capita has doubled since 1975.

## Subject vocabulary

**Human Development Index** a composite index that measures a country's achievements in three areas: life expectancy rates, literacy rates, and income per head

**natural resources** assets, such as mineral deposits and timber, that occur in nature and can be used in production

**GNI** the sum of incomes (rent, wages, interest, and profit) earned by residents of a country in a given period of time, including earnings from overseas investments, less the amount foreigners earn in the country that is sent back to their home countries

**Gini-coefficient** the Gini coefficient is the ratio of the area under the Lorenz curve to the area under the 45 degree diagonal (line of perfect equality) on a graph of the Lorenz curve. It is a number between zero and one. Zero corresponds to perfect equality and one to perfect inequality.

**national income** the sum of all income (wages, profits, rents, and interest) earned in a country in a given period of time

**GDP** gross domestic product is the monetary value of all the finished goods and services produced within a country in a given period of time, usually measured over a year

**primary goods** a good that has not been processed and is in a raw state (e.g. fruit/wheat)

**export revenue** income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

## Glossary

**ally** a person or organization that cooperates with or helps another in a particular activity

Bangladesh spends a much smaller proportion of ODA on health and other social sectors than Mali but its life expectancy rate is nearly 70 years. This represents an increase of 5 years since 2002. Literacy rates have increased quickly as well. In 2002 the adult literacy rate was 50%, by 2012 it was 60%.

**Model sentence:** Industrialization reduces dependency on the production of primary goods and can increase the rate of economic growth and economic development, leading to increases in the value of HDI in a country.

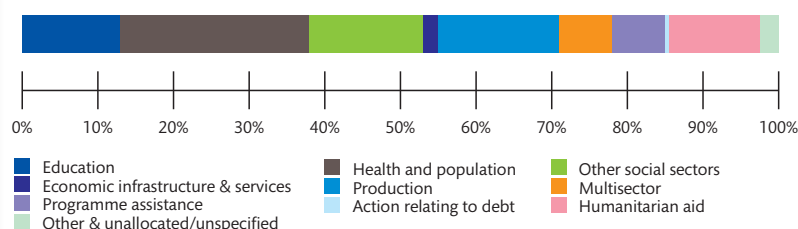
#### Mali

Receipts	2010	2011	2012
Net ODA (USD million)	1,089	1,217	1,001
Bilateral share (gross ODA)	63%	62%	73%
Net ODA/GNI	12.1%	12.6%	10.2%
Net private flows (USD million)	-39	-15	-23

For reference	2010	2011	2012
Population (million)	14.0	14.4	14.9
GNI per capita (Atlas USD)	660	670	660

Top Ten Donors of gross ODA (2011–12 average)	(USD m)
1 United States	311
2 IDA	114
3 EU Institutions	113
4 Canada	105
5 France	79
6 Netherlands	53
7 AfDF	51
8 Germany	46
9 Sweden	31
10 IMF (Concessional Trust Funds)	27

**Bilateral ODA by Sector (2011–12)**



**Table 84.2** Source: OECD

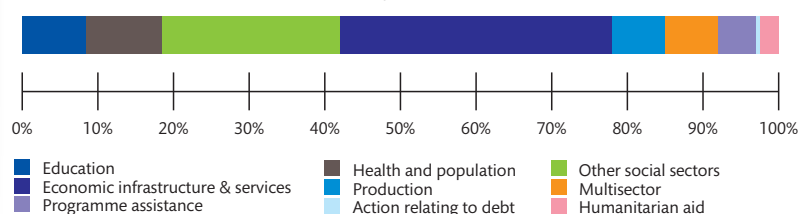
#### Bangladesh

Receipts	2009	2010	2011
Net ODA (USD million)	1,226	1,415	1,498
Bilateral share (gross ODA)	48%	50%	55%
Net ODA/GNI	1.3%	1.3%	1.3%
Net private flows (USD million)	182	-82	369

For reference	2009	2010	2011
Population (million)	147.0	148.7	150.5
GNI per capita (Atlas USD)	640	700	770

Top Ten Donors of gross ODA (2010–11 average)	(USD m)
1 IDA	359
2 United Kingdom	299
3 AsDB Special Funds	287
4 EU Institutions	174
5 Japan	172
6 United States	147
7 Netherlands	78
8 Canada	74
9 Denmark	72
10 Germany	71

**Bilateral ODA by Sector (2010–11)**



**Table 84.3** Source: OECD

### Subject vocabulary

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**recession** two consecutive quarters of negative economic growth

**indebtedness** occurs when a household, firm, or organization owes money

## Does aid promote economic development?

The purposes and benefits of aid have already been discussed in detail in this section. Some of the possible disadvantages of aid are discussed below.

### Why is corruption a disadvantage?

**Corruption** in LDCs is widespread. Aid money is stolen by political leaders to use for their own benefit. For example, aid money is stolen and sent out of the country into personal bank accounts of politicians and their families. Aid is stolen and used to build large and luxurious homes for those in power. Those in power steal humanitarian aid, such as food and medicine and sell it for profit.

### Why is tied aid a disadvantage?

An LDC that receives tied aid must accept specific conditions before a donor country gives aid. The aid might have to be spent on a particular project or the LDC must agree to use the aid to buy the donor country's goods. This means that the LDC cannot buy its imports at lowest cost, therefore not minimizing the **costs of production** of firms in the LDC. Aid is sometimes tied to the purchase of **capital** from the donor country. This can cause an increase in **technological unemployment**, particularly in a country with a large **surplus** of low skilled labour.

### Why are a high degree of dependency on aid and the volatility of aid disadvantages?

When a country is very dependent on aid, measured as a percentage of **GNI**, the government's revenue goes up and down as the aid flowing into the country changes, making it difficult for the government to plan its expenditure effectively.

The proportion of income earned in LDCs that is taxed is relatively low. This is because there are large informal markets. LDCs lack the infrastructure needed to collect **tax revenue** effectively and enforce the payment of taxes. Aid acts as a disincentive for governments to improve the effectiveness of raising tax revenue.

The well-being of people living in a very poor country that needs aid to pay for basic health and education services is very badly affected by fluctuations in aid.

### Why is procyclical aid a disadvantage?

Aid is **procyclical** when aid is given as the economy is growing and is on the upward slope of the **business cycle**. Procyclical aid can worsen the negative impacts on the economy when **GDP** falls and the economy is on the downward slope of the business cycle. **Countercyclical** aid, given when the economy is slowing and unemployment is rising, lessens the negative economic consequences of a **recession**.

### Why is the ineffectiveness of aid agencies a disadvantage?

While there have been increases in ODA in the last decade lots of research has found that a relatively small proportion of all aid given by the donor countries reaches the LDCs. Some researchers found that many of the agencies involved in the distribution of aid are ineffective and wasteful. Much of the aid given is not used to increase the well-being of the poor in LDCs.

### Why is aid in the form of loans a disadvantage?

Grants do not have to be repaid. They represent a transfer of currency from relatively rich developed countries to LDCs. Loans have to be repaid as do the interest payments on the loans. Over time the total **indebtedness** of LDCs increase. Debts must be paid back in the future, reducing the amount of income in the economy available for spending on other things such as education and health.

## Glossary

**corruption** illegal/immoral behaviour particularly by person(s) in power

## Subject vocabulary

**costs of production** the amount the firm pays for the factors of production used to produce goods or services

**capital** manufactured goods that are used in the production of other goods

**technological unemployment** unemployment caused by technological changes. It occurs when capital replaces labour in the production of goods.

**surplus** occurs when quantity supplied is greater than quantity demanded, another term for excess supply

**GNI** the sum of incomes (rent, wages, interest, and profit) earned by residents of a country in a given period of time, including earnings from overseas investments, less the amount foreigners earn in the country that is sent back to their home countries

**tax revenue** the income the government receives through the levying and collection of taxes

**procyclical** the movement of an economic indicator that moves in the same direction to that of the current trend of the business cycle. An indicator that increases when the economy is growing is described as procyclical.

**business cycle** the fluctuations in economic activity over time. There are four stages of the business cycle: (1) recession, when economic activity slows down; (2) trough, when the recession is at its deepest; (3) recovery, when the economy begins to grow; and (4) peak/boom, when economic activity is high.

**GDP** gross domestic product is the monetary value of all the finished goods and services produced within a country in a given period of time, usually measured over a year

**countercyclical** movement of an indicator in a direction opposite to that of the current trend of the business cycle, e.g. an indicator that increases when the economy slows down is described as countercyclical.

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## Subject vocabulary

**terms of trade** the amount of imported goods a country can buy per unit of its exported goods

**subsidies** payments made by government to firms per unit of output

**excess supply** occurs when quantity supplied is greater than quantity demanded

**savings gap** occurs when low incomes earned in a country are not high enough to provide savings for those who wish to borrow for investment purposes

**productivity gap** the difference between the output per worker in one country compared with the output per worker in another country

**foreign direct investment** cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

**economies of scale** the cost advantages gained by a firm from increasing the scale of its production. Average cost falls in the long run as the size of a firm's operation increases.

**export revenue** income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

**barriers to trade** restrictions imposed by a government on the free exchange of goods or services between countries

**import substitution** the promotion by government of domestic industries by protecting domestic producers

**infant industries** a new industry which often is not able to compete against established foreign industries and therefore needs to be protected from the competition through subsidies and tariffs

**poverty cycle** occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low.

**loanable funds** the sum of money in an economy that is saved rather than used for consumption and made available to those wishing to borrow

## Compare and contrast the roles of aid and trade in economic development

LDCs are over-dependent on the production of primary goods in which they have a comparative advantage. However, as explained on pages 262–63, the world prices of such goods are falling in the long term, leading to a deterioration in the **terms of trade** and a fall in export revenues.

Many LDCs are dependent on agricultural output for export revenues. World productivity in this industry is increasing, pushing up supply and pushing world prices down. Governments in developed countries give **subsidies** to farmers producing particular agricultural goods, leading to increases in output and **excess supply**. The excess is often dumped in LDCs at below cost price, a price at which the LDCs are unable to compete, thereby harming their ability to raise export revenue with which they can buy much needed imports, such as capital goods and manufactured consumer goods.

Income earned over time falls, leaving less available for saving and investment. A large **savings gap** and investment gap leads to an increase in the **productivity gap** because LDCs are unable to buy the capital goods needed to increase productivity. With low income, LDCs are unable to save in order to invest in the production of manufactured goods, thereby reinforcing their dependency on a narrow range of primary goods. The cycle of low levels of savings, low investment, and low income continues and LDCs are unable to break out of the poverty cycle.

As discussed previously in this unit, aid, along with **foreign direct investment**, can be used to provide LDCs with the investment needed to improve the productivity of existing industries and to help them on the road to industrialization, thereby reducing their dependency on the production of primary goods. If the developed countries also removed the subsidies on agricultural output, farmers in LDCs could expand their markets into the developed world and thereby benefit from greater **economies of scale** and lower average costs. An increase in income could lead to an increase in savings and investment and reduce aid dependency.

However, the removal of subsidies on agricultural goods would harm the LDCs that are net-importers of food. The world price of food would increase as subsidies are removed. More of the LDCs' **export revenue** would be needed to buy imported food leading to deterioration in their terms of trade. A food shortage causes human suffering, leading to social unrest and political instability.

Developed countries that reduce or remove **barriers to trade** might only do so if LDCs do the same. **Import substitution** would be ineffective if the **infant industries** are not protected from the developed countries' cheaper imports. This reduces the LDCs' chances of industrializing and breaking their dependency on the production of primary goods.

Economists disagree over the role trade and aid plays in the economic development of LDCs. Many argue that LDCs are so poor that in order to break free from the **poverty cycle** the developed world must provide aid as well as agree to a system of trade barriers that favours LDCs, allowing LDCs to export their goods free of tariffs whilst at the same time being able to protect their infant manufacturing industries.

## Examine the current roles of the IMF and the World Bank in promoting economic development

### What is the World Bank and what are its aims?

The World Bank is an agency that provides advice and loans. It is owned by 180 countries. It raises **loanable funds** in the world financial markets and from the governments of the 180 countries. Therefore, the World Bank provides multilateral funds. The interest rate the World Bank charges is determined by a number of factors including the rate at which the World Bank has to borrow and the creditworthiness of the country that is borrowing. But it does provide low-interest loans and grants to poor countries for education and health.

The World Bank is made up of two main institutions:

The International Bank for Reconstruction and Development (IBRD) focuses on providing loans and advice to middle income countries.

The International Development Association (IDA) focuses on providing loans and advice to LDCs.

Its stated aims are listed below:

1. Investing in people through health and education.
2. Protecting the environment.

3. Supporting private sector development.
4. Helping governments provide good quality services.
5. Promoting reforms to create a stable macroeconomic economy that is required for long-term investment.

Its mission statement is: 'to reduce poverty and improve living standards through sustainable growth and investment in people'.

Like the IMF the World Bank believes that relatively **free markets** work best.

The World Bank focuses on relatively small-scale projects aimed at improving the basic needs of the people. The environmental impact of each project is assessed. Each project should promote **sustainable economic development**.

The World Bank focuses on providing advice and loans in the following areas of the world:

Africa, East Asia and the Pacific, Europe and Central and South Asia, Latin America and the Caribbean, and North Africa.

Most of the World Bank's work is done in the following development areas: agriculture, transport, rural and urban development, water and sanitation, health, nutrition, population control, gender equality, and macroeconomic policy.

### What are some of the criticisms of the World Bank?

Some economists believe that government plays a very important role in managing demand through **fiscal policy** and **monetary policy**. They argue that the World Bank's free market, non-interventionist approach has a negative impact on the success of the World Bank's aims and can lead to a worsening of economic development.

Such economists argue that firms and households in LDCs do not have enough income to invest, or spend, and therefore the economy cannot grow. They argue that when this is the case the government should increase **aggregate demand** through **expansionary fiscal policy** and **expansionary monetary policy**.

However, the World Bank often makes it a condition of its help that governments must put in place **contractionary fiscal policy** and **contractionary monetary policy**. Higher interest rates, higher taxes, and a reduction in government expenditure should help to keep the **budget deficit** under control and reduce inflationary pressures. However, increasing interest rates and taxes and reducing government expenditure reduces the possibility of **economic growth** because of the likely fall in consumption and investment. Cuts in government expenditure also lead to a fall in spending on education and health, thereby restricting economic development.

**Model sentence:** Contractionary fiscal and monetary policy leads to a fall in aggregate demand and low rates of economic growth leaving households with less income to satisfy basic needs and wants.

The World Bank promotes **trade liberalization** and can make it a condition of a loan that **barriers to trade** be removed, thereby leaving domestic industries unprotected. Some domestic industries will go out of business because of the price competitive foreign imports, leading to an increase in unemployment and a fall in income thereby limiting the benefit the loan may bring. Some economists argue that in some cases the value of the HDI has fallen because of loans from the World Bank.

When an LDC accepts a loan or grant from the World Bank the LDC loses control of its fiscal policy and monetary policy. The government is unable to set policy in response to changes in economic conditions. Instead it must follow policies that are controlled by an institution that has not been elected by the citizens of the LDC.

Loans and the interest must be repaid by the borrowing country. Borrowing increases the **indebtedness** of a country. Debts build up over time. Repayments must be made in the future, thereby reducing the income available to spend on much needed services. More **tax revenue** is needed to pay these debts leaving consumers with less to spend on satisfying their basic needs. High levels of debt reduce future levels of income leading to falls in future levels of aggregate demand.

**Model sentence:** Trade liberalization leaves infant industrial industries unprotected, therefore many will close down leading to higher unemployment, lower incomes, and an increase in poverty.

### Subject vocabulary

**free market** a market where the forces of demand and supply are allowed to operate without any forms of intervention

**sustainable economic development** economic growth that meets the needs and wants of the current generation in such a way that does not prevent future generations from meeting their needs and wants

**fiscal policy** government policy designed to achieve macroeconomic objectives through government expenditure and taxation

**monetary policy** the control of the supply of money by the central bank to affect the economy (e.g. changing interest rates)

**aggregate demand** the total demand for goods and services in the economy at a given price level in a given period of time

**expansionary fiscal policy** policy involving the increase of government spending and/or the reduction of taxation

**expansionary monetary policy** government policy involving the expansion of the money supply and the reduction of the interest rate

**contractionary fiscal policy** policy involving the reduction of government spending and/or increase of taxation

**contractionary monetary policy** policy involving the reduction of the money supply and the increase of interest rates

**budget deficit** occurs when government expenditure is greater than tax revenue

**economic growth** an increase in real GDP

**trade liberalization** the removal of, or reduction in, the international barriers to trade, such as tariffs and quotas

**barriers to trade** restrictions imposed by a government on the free exchange of goods or services between countries

**indebtedness** occurs when a household, firm, or organization owes money

**tax revenue** the income the government receives through the levying and collection of taxes

## Subject vocabulary

**exchange rate** the price of a country's currency in terms of another currency

**foreign currency reserves** the amount of foreign currency and gold that is held by the central bank of a country

**foreign direct investment** cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

**portfolio investment** the purchase of a variety of financial assets such as shares and bonds

**current account deficit** occurs when the amount of money flowing out of a country from the trade in goods and services, investment income, and transfers is greater than the amount flowing in

**fixed exchange rate** an exchange rate system in which the value of a currency in respect to another currency is set and maintained

**inflation** an increase in the general level of prices of goods/services in an economy over a given time period, usually a year

**export revenue** income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

**investment** the addition to capital stock

**raw materials** the basic material from which a good is made

**capital** (goods) manufactured goods that are used in the production of other goods

**devaluation** the official lowering of the value of a country's currency in a fixed exchange rate system

**current account** a record of the amount of money flowing out of a country and into the country from the rest of the world from the trade in goods and services, investment income, and transfers in a given period of time

**Model sentence:** An increase in a LDC's debt increases the amount of future income needed to pay off the debt, leaving less income to spend on health and education thereby harming economic development.

## What is the International Monetary Fund (IMF) and what are its aims?

The IMF is an organization of 188 countries. The funds the IMF needs in order to operate come from the member countries. The contribution of money is called a quota. Voting power of each country in the decision-making process of the IMF is in proportion with the amount of each country's quota. Large countries, such as the US, have a great influence over IMF policy decisions because the US pays the biggest quota.

The IMF's goal is to promote international economic cooperation in order to increase international trade, economic stability, and sustainable economic growth and thereby reduce global unemployment and poverty.

One of its aims is to achieve global **exchange rate** stability. A country goes to the IMF for financial help when it has a shortage of **foreign currency reserves**. The shortage might be caused by a lack of **foreign direct investment** or **portfolio investment**. A country may need more foreign reserves to maintain its exchange rate or to finance its **current account deficit**.

For example, a country with a large current account deficit might reduce the value of its currency in order to reduce the price of its exports and increase the price of its imports and thereby reduce the current account deficit. But this leads to exchange rate instability. Therefore, the IMF loans money to the country which is a current transfer that increases the flow of money in to the country's current account, thereby reducing its current account deficit. The country no longer needs to reduce the value of its currency and exchange rate stability is maintained.

IMF funds might be needed by a country that has agreed to fix the value of its currency against another currency. For example, a country wanting to join the EU must maintain a **fixed exchange rate** between its currency and the euro for a given period of time before it is allowed to join. If there is downward pressure on the fixed exchange rate the country must increase demand for its currency by selling its foreign reserves and buying its own currency, thereby increasing demand for its own currency and pushing the exchange rate up. If the country does not have the reserves of foreign currency to do this the exchange rate will fall and the country will not be able to join the EU. The IMF is keen that countries keep to these agreements and therefore will provide the foreign reserves so that the exchange rate can be maintained.

Many LDCs have large debts that they are unable to finance because of low levels of income. The IMF steps in to renegotiate the terms under which the debt has to be repaid and provides funding for the repayment of debt. But there are conditions put in place before the IMF will agree to help.

The IMF usually insists that the LDC introduce contractionary (deflationary) fiscal policy and contractionary (deflationary) monetary policy, these policies lead to a fall in aggregate demand which includes the demand for imports thereby reducing the amount of foreign reserves needed to buy them. A fall in aggregate demand helps to keep **inflation** at low levels, thereby increasing the LDCs, international competitiveness and increasing the amount of income flowing into the LDC from **export revenue**. A contractionary (deflationary) monetary policy requires a high interest rate on borrowing which reduces aggregate demand. High interest rates also act as an incentive to save, thereby providing more funds available for **investment**.

**Model sentence:** Contractionary fiscal and monetary policy cause a fall in aggregate demand which includes a fall in the demand for imports. The fall in AD reduces inflation leading to increases in the demand for exports and an improvement of the current account balance.

The IMF may also require an LDC to devalue its currency. An LDC might over-value its currency in order to reduce the price of imported goods, such as **raw materials** and **capital** goods. Also, an over-valued currency reduces the repayments on debt that must be paid back in a foreign currency. **Devaluation** reduces the LDC's dependence on imports, encourages consumption of domestically produced goods, and makes exports more price competitive. The flow of income leaving the country falls and the flow of income into the country increases. This leads to a reduction in the current account deficit and a fall in the amount of foreign reserves necessary to balance the **current account**.

**Model sentence:** Devaluation reduces the demand for imports and increases demand for exports leading to a reduction in the current account deficit.



## What are the criticisms of the IMF?

Discussed below are some of the disadvantages for LDCs associated with dealing with the IMF.

### What are the costs of contractionary fiscal policy and monetary policy?

Some economists argue that the conditions laid down by the IMF lead to an increase in poverty and hardship for citizens of LDCs. Contractionary fiscal policy and contractionary monetary policy that must be introduced as a condition for financial help reduces aggregate demand leading to a **recession**. Unemployment increases and household incomes and **tax revenue** falls. **Absolute poverty** increases and governments do not have the revenue to pay for basic services.

Part of contractionary fiscal policy is a reduction in government expenditure. The government of the LDC must reduce spending on the provision of basic services. This has a negative impact on **economic development** and the welfare of its citizens.

Part of contractionary monetary policy is high interest rates. A high **interest rate** does increase the incentive to save but it also reduces the incentive to borrow for investment purposes. A fall in investment leads to an increase in the **productivity gap**, an increase in relative **average costs** and a fall in international competitiveness.

**Model sentence:** A fall in government spending leads to a fall in expenditure on education and health and a fall in the value of HDI.

### What are the costs of devaluation?

**Model sentence:** Devaluation of a currency of an LDC leads to an increase in the price of imported necessities leaving some people unable to satisfy basic needs thereby increasing absolute poverty.

Domestic firms have to pay more for imported raw materials which increases **costs of production** leading to higher prices and a fall in international competitiveness and more job losses.

### What are the costs of trade liberalization?

A condition of help from the IMF is the removal of **barriers to trade**. In order to get financial help an LDC must remove trade barriers that protect its domestic industries. The domestic industries may go out of business because they are not able to compete against lower priced imports. This condition means that import substitution industrialization will be difficult to achieve because the country cannot protect its **infant industries** thereby leaving the LDC dependent on the production of **primary goods**.

The IMF decision making is dominated by rich developed countries. These countries, therefore, decide on the conditions that LDCs must agree to. The conditions on **trade liberalization** are likely to benefit the developed countries and not the LDCs.

### Test your understanding of this unit by answering the following questions

- Distinguish between bilateral aid and multilateral aid.
- Distinguish between official development assistance and humanitarian aid?
- Discuss whether or not aid promotes economic development.
- Why do developed countries give aid?
- Explain the possible disadvantages to economic development of assistance from the IMF.
- Evaluate the World Bank's impact on economic development in LDCs.

### Subject vocabulary

**recession** two consecutive quarters of negative economic growth

**tax revenue** the income the government receives through the levying and collection of taxes

**absolute poverty** occurs when people do not have enough resources to satisfy their basic needs

**economic development** the sustained increase in the standard of living and well-being of the population of a country

**interest rate** the percentage amount charged by a lender for money borrowed or paid to a person for saving money

**productivity gap** the difference between the output per worker in one country compared with the output per worker in another country

**average cost** is equal to total cost divided by quantity of output

**costs of production** the amount the firm pays for the factors of production used to produce goods or services

**barriers to trade** restrictions imposed by a government on the free exchange of goods or services between countries

**infant industries** a new industry which often is not able to compete against established foreign industries and therefore needs to be protected from the competition through subsidies and tariffs

**primary goods** a good that has not been processed and is in a raw state (e.g. fruit/wheat)

**trade liberalization** the removal of, or reduction in, the international barriers to trade, such as tariffs and quotas